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In the Supreme Court of the United States

OCTOBER TERM, 1956

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NEIL SULLIVAN AND GRACE SULLIVAN

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JAMES ROSS AND ANN ROSS

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SAM MESI

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

J. LEE RANKIN,
Solicitor General,
CHARLES K. RICE,
Assistant Attorney General,
MEYER ROTHWACKS,
Attorney,
Department of Justice, Washington 25, D. C.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgments of the Court of Appeals for the Seventh Circuit in these cases involving substantially identical questions (Rule 23 (5)).

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court in the *Sullivan* and *Ross* cases (*Sullivan* R. 5–19)[1] are not officially reported. The opinion of the Court of Appeals in those cases (Appendix, *infra*, pp. 16–18) is reported at 241 F. 2d 46. The Tax Court's findings of fact and opinion in the *Mesi* case (*Mesi* R. 56–68) are reported at 25 T. C. 513. The opinion of the Court of Appeals in the *Mesi* case (Appendix, *infra*, pp. 21–23) is not yet reported.

JURISDICTION

The judgments of the Court of Appeals in the *Sullivan* and *Ross* cases (Appendix, *infra*, pp. 19, 20) were entered on February 13, 1957. The judgment of the Court of Appeals in the *Mesi* case (Appendix, *infra*, p. 24) was entered on April 5, 1957. The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

QUESTION PRESENTED

The taxpayers, while conducting gambling establishments, made certain payments for the rental of the premises and for the wages of their employees. These payments were prohibited by the criminal statutes of the State of Illinois.

The question is whether such payments, made in violation of State law, are deductible under the Inter-

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[1] References designated "*Sullivan* R. " are to the appendix to the taxpayers' brief in the Court of Appeals in the *Sullivan* and *Ross* cases. References designated "*Mesi* R. " are to the separately printed record in the Court of Appeals in the *Mesi* case.

nal Revenue Code of 1939, Section 23 (a) (1) (A), as ordinary and necessary expenses incurred in carrying on a trade or business.

STATUTES INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income, there shall be allowed as deductions:

(a) [as amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798, 819] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(26 U. S. C. 1952 ed., Sec. 23 (a).)

Illinois Revised Statutes (1945), c. 38 (Criminal Code):

CONSPIRACY

* * * * *

139. *To do an illegal act—Boycott—Black list.* § 46. If any two or more persons conspire or agree together, * * * to do any illegal act injurious to the public trade, health, morals, police, or administration of public justice, * * * they shall be deemed guilty of a conspiracy;

and every such offender, * * * and every person convicted of conspiracy at common law, shall be imprisoned in the penitentiary not exceeding five years, or fined not exceeding $2,000, or both.

* * * * * *

, 140. *Against state, etc.* § 1. * * * That if two or more persons conspire either to commit any offense against the State of Illinois, or any county, incorporated city, village, town or township thereof, * * * in any manner, or for any purpose, and one or more of such parties, do any act to effect the object of the conspiracy, all parties to such conspiracy shall be liable to a penalty of not less than one hundred dollars, and not more than five thousand dollars, and to be imprisoned in the pentitentiary for a term of not less than one year nor more than two years or imprisonment in the county jail for any period not exceeding two years. Provided, however, this Act shall not be construed to modify or repeal any other law in force in this State.

GAMBLING AND GAMBLING DEVICES

336. *Book-making and pool-selling unlawful.* § 1. * * * That any person who keeps any room, shed, tenement, tent, booth, or building, or any part thereof, or who occupies any place upon any public or private grounds within this state, with any book, instrument or device for the purpose of recording or registering bets or wagers, or of selling pools, or any person who records or registers bets or wagers, or sells pools upon the result of any trial or contest of skill, speed or power of endurance of man or

beast, or upon the result of any political nomination, appointment or election, or being the owner, lessee or occupant of any room, shed, tenement, tent, booth, or building, or part thereof, knowingly permits the same to be used or occupied for any of these purposes, or therein keeps, exhibits or employs any device or apparatus for the purpose of recording or registering such bets or wagers, or selling of such pools, or becomes the custodian or depository for hire or privilege, of any money, property, or thing of value staked, wagered or pledged upon any such result, shall be punishable by imprisonment in the county jail for a period not longer than one year or by fine not exceeding $2,000 or both. * * *

ACCESSORIES

582. *Before the fact.* § 2. An accessory is he who stands by, and aids, abets or assists, or who not being present, aiding, abetting or assisting, hath advised, encouraged, aided or abetted the perpetration of the crime. He who thus aids, abets, assists, advises or encourages, shall be considered as principal, and punished accordingly.

STATEMENT

Sullivan and Ross cases.—During the years in question the taxpayers, Neil Sullivan and James Ross, were engaged, as equal partners, in accepting wagers on horse races, commonly known as bookmaking, in Chicago, Illinois.[2] (*Sullivan* R. 5.) This bookmaking

[2] Grace Sullivan and Ann Ross are taxpayers by reason of filing joint returns with their husbands.

was illegal under the Criminal Code of Illinois. (*Sullivan* R. 16–17.)

The partnership in the conduct of its bookmaking paid total wages to its six or seven employees and claimed deductions as follows (*Sullivan* R. 12):

Year	Wages
1948	$18,950.00
1949	22,935.00
1950	23,390.00

The services of the employees for these wages were performed in the illegal operation of the partnership, including the recording of bets. (*Sullivan* R. 12.)

The activities were conducted in various leased rooms on the upper floors of a hotel located in the central business district of Chicago. On frequent occasions the locations were raided by the police. The partnership changed its rooms in the hotel from time to time because of such raids. (*Sullivan* R. 7, 11.) The partnership paid rent to the lessor of the various hotel rooms and claimed deductions as follows (*Sullivan* R. 12):

Year	Rent
1948	$8,735.00
1949	9,200.00
1950	9,215.00

The lessor knowingly permitted these rooms to be used for the purposes of bookmaking, and the parties knew that both the payment and receipt of rentals were in violation of Sections 336 and 582 of the Illinois Criminal Code. (*Sullivan* R. 13, 17.)

The acts performed by the employees of the partnership and the lessor in return for the wages received by the former, and the rent received by the latter, constituted violations of Section 336 of the

Criminal Code of the State of Illinois. The payment of the wages and rent constituted a violation of Section 582 of the Code. (*Sullivan* R. 13.)

The Tax Court held that the deduction of wages and rent must be disallowed since to permit the deductions would be a frustration of the declared public policy of Illinois. (*Sullivan* R. 17.)

The Court of Appeals reversed the judgment of the Tax Court. It remanded the cause solely for the redetermination of an issue not before this Court. (Appendix, *infra*, p. 18.)

The Mesi case. During the year 1946, the taxpayer was engaged in accepting wagers on horse races, commonly known as bookmaking. He conducted his gambling operations from three or four different locations at various times during that year. He had a principal location for which he paid an annual rental, but he was compelled to move about because of raids by the police. He operated from a garage and, during certain periods in 1946, in basements, hallways, and alleyways. (*Mesi* R. 57.)

The taxpayer spent little time at his bookmaking establishment during the daytime. He occasionally visited it in the afternoons and usually went there in the evenings when the summaries of the day's activities were being prepared. Although engaged in illegal activities and although his establishment was raided several times during 1946, he was not personally arrested at any time during that year. (*Mesi* R. 57.)

The taxpayer's gambling activities were extensive. Although the great majority of the bets taken were small, being for 50 cents, $1, or $2, and though no bets in excess of $100 were accepted, incoming bets totaled $793,287.50 in 1946. He employed six or seven persons during that year, paying them gross wages in the amount of $14,563.84. Among these employees were a cashier, two or three sheet writers who accepted and entered the incoming bets, men on the "hard cards,"[3] and a doorman. (*Mesi* R. 57–58.)

The services performed by taxpayer's employees in return for wages constituted a violation of Section 336 of the Criminal Code of the State of Illinois, and the payment of the wages, in and of itself, constituted an illegal act. (*Mesi* R. 60, 67.)

The Tax Court, in an opinion reviewed by the whole court, determined that the wages paid to the taxpayer's employees were not deductible for income tax purposes since the payment thereof had been an illegal act under the law of Illinois and had violated a clearly defined and declared public policy of that state. (*Mesi* R. 64–67.)

The Court of Appeals reversed the judgment of the Tax Court and held that the wages paid by the taxpayer were proper deductions. The case was remanded for further proceedings with respect to an issue not raised here. (Appendix, *infra*, p. 23.)

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[3] The "hard cards" were large cardboard sheets, one for each track, which showed the entries for the day, the jockey, and the probable odds. (*Mesi* R. 58.)

REASONS FOR GRANTING THE WRIT

These cases raise the fundamental question of the deductibility of illegal expenditures under the income tax laws of the United States. In holding illegal payments by gamblers to be "ordinary and necessary" expenses of a "trade or business" the Court of Appeals has decided, adversely to the Government, an important question of federal law which has been explicitly left open by this Court and on which the lower courts have failed to develop a uniform rule.

1. This Court has not yet decided the question of whether payments which constitute a violation of state law or are incidental to such a violation may be considered as ordinary and necessary business expenses, and thus used to reduce the income tax of those making them. In *United States* v. *Sullivan*, 274 U. S. 259, 264, Mr. Justice Holmes, replying to a suggestion that one engaged in the illicit traffic of liquor might be entitled to deduct illegal expenses such as bribery, stated for the Court: "This by no means follows, but it will be time enough to consider the question when a taxpayer has the temerity to raise it." In *Lilly* v. *Commissioner*, 343 U. S. 90, 94–95, the Court again left the question open:

> We do not have before us the issue that would be presented by expenditures which themselves violated a federal or state law or were incidental to such violations. In such a case it could be argued that the outlawed expenditures, by virtue of their illegality, were not "ordinary and necessary" business exp

> penses within the meaning of § 23 (a) (1) (A). [citations omitted]

The issue there left open is presented in these cases. Respondents paid persons to break the law—to run a gambling establishment and to provide space within which it could be run. Respondents contend that these illegal payments, including those which induced persons to commit crimes, may be deducted as the "ordinary and necessary" expenses of carrying on a "trade or business." The court below has so held. The Government disagrees. This is an issue of obvious importance which ought to be resolved by this Court.

2. In *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326, the Court held that lobbying expenditures of a corporation were properly treated as non-deductible expenses. The Court found that under the statutory standard of "ordinary and necessary" a line could be drawn "between legitimate business expenses and those arising from that family of contracts to which the law has given no sanction." (314 U. S. at 339).

Commissioner v. *Heininger*, 320 U. S. 467, suggested the rule that expenditures might be deducted except where to allow the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct. (320 U. S. at 473–474). This was assumed by the Court to be the law in *Lilly* v. *Commissioner*, *supra*, where the Court stated (343 U. S. at 97):

> The policies frustrated must be national or state policies evidenced by some governmental declaration of them.

Although these decisions are not direct holdings on the question raised in this petition, they indicate a general approach which is different from that followed by the court below.

3. The decisions below are also inconsistent with the reasoning of decisions of those courts of appeals which have followed the "public policy" doctrine in a wide variety of situations.[4] In many of the cases, the expense or loss which was denied deduction was no less an integral part of the taxpayer's activities than are the expenses involved here.[5] For example, see *United States* v. *Algemene Kunstzijde Unie, N. V.*, 226 F. 2d 115 (C. A. 4th), certiorari denied, 350 U. S. 969 (loss incurred by foreign corporation doing business in this country when certain of its assets were vested by the United States under the Trading with the Enemy Act); *Fuller* v. *Commissioner*, 213 F. 2d 102 (C. A. 10th) (loss incurred when whiskey, being sold in a dry state, was confiscated by law enforcement officers); *Rugel* v. *Commissioner*, 127 F. 2d 393 (C. A. 8th) (payments to influential political precinct captain to obtain printing contract); *Harden M. Loan Co.* v. *Commissioner*, 137 F. 2d 282 (C. A. 10th) (payment

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[4] The decisions in the present cases followed the reasoning of *Commissioner* v. *Doyle* and, for the Court's convenience, the *Doyle* opinion is reproduced in the Appendix, *infra*, pp. 25–32.

[5] The Seventh Circuit's decisions in the instant cases also appear to be inconsistent with its prior decisions in *Lentin* v. *Commissioner*, 226 F. 2d 695, 699, certiorari denied, 350 U. S. 934; *Standard Oil Co.* v. *Commissioner*, 129 F. 2d 363, 371, certiorari denied, 317 U. S. 688; and *Humphreys* v. *Commissioner*, 125 F. 2d 340, 343, certiorari denied, 317 U. S. 637.

for political influence, disguised in the form of sales commissions). There are also many Tax Court decisions which apply the same general principle to deny deductibility of expenses which are contrary to public policy. See, for example: *Giubbini* v. *Commissioner,* decided October 27, 1939 (1939 P-H B. T. A. Memorandum Decisions, par. 39,471) (payments by abortionist to his procurers); *Estate of Karger* v. *Commissioner,* decided July 13, 1954 (1954 P-H T. C. Memorandum Decisions, par. 54,204) (salaries paid to abortionist's assistant); *Kelley-Dempsey & Co.* v. *Commissioner,* 31 B. T. A. 351 (amounts paid as commercial extortion); *Fazzio* v. *Commissioner,* decided September 7, 1943 (1943 P-H T. C. Memorandum Decisions, par. 43,410) (fees paid for membership identification tags on pinball machines where purpose of association was illegal); *Reliable Milk & Cream Co., Inc.* v. *Commissioner,* decided August 20, 1938 (1938 P-H B. T. A. Memorandum Decisions, par. 38,290) (payments to racketeers made under fear of assault). A more complete list of decisions will be found in 4 Mertens, *Law of Federal Income Taxation,* Sections 25.131-25.135.

The public policy doctrine has also served as a basis for disallowing the deduction of fines or penalties incurred through violations of federal and state statutes so as to avoid a frustration of the public policy expressed in these statutes. See 4 Mertens, *supra,* Section 25.131. Of particular significance here are the decisions disallowing the deduction where the violations were inadvertent, unintentional or even

unavoidable in the conduct of the taxpayer's business. *Great Northern Railway Co.* v. *Commissioner,* 8 B. T. A. 225, 234, affirmed, 40 F. 2d 372 (C. A. 8th), certiorari denied, 282 U. S. 855; *Terminal Railroad Assn. of St. Louis* v. *Commissioner,* 17 B. T. A. 1135, 1154–1155, 1169, affirmed, *sub nom. Tunnel R. R. of St. Louis* v. *Commissioner,* 61 F. 2d 166 (C. A. 8th), certiorari denied, 288 U. S. 604; *Hoover Motor Express Co., Inc.* v. *United States,* 241 F. 2d 459 (C. A. 6th), pending on petition for a writ of certiorari, No. 862, this Term; *Tank Truck Rentals, Inc.* v. *Commissioner* (C. A. 3d), decided March 6, 1957 (1957 C. C. H., par. 9466), pending on petition for a writ of certiorari, No. 932, this Term.

We believe that the *Hoover Motor Express* and *Tank Truck Rentals* cases, *supra,* were correctly decided. To the extent, however, that these cases hold that the taxpayers may not deduct fines or penalties resulting from violations of state statutes regulating weight limits of trucks, the decisions appear to us[6] to be out of harmony with the decisions below and the "integral" "concomitant" test which they introduce. That is, where, in the normal conduct of a business, unintentional, inadvertent violations of law occur, such violations would appear to be an integral part of the business, and the rationale employed by the court below would lead to the conclusions that the fines

[6] The court below thought that a distinction could be made between payments of fines, penalties and bribes, which it would consider unnecessary, and illegal payments which were an "integral part of a business". See its opinion in the *Doyl* case, *infra,* at page 29.

ought to be deductible. Consequently, those decisions and the decisions below cannot be fairly reconciled and, concurrently with the filing of the petition in these cases, the Government is filing a memorandum which does not oppose the granting of certiorari on the petitions which have been filed by the taxpayers in the *Hoover Motor Express* and *Tank Truck Rentals* cases.

4. It is the Government's view that the decisions below are erroneous. We do not believe that it is "necessary" to break the law or, in particular, that it is "necessary" to hire persons to commit crimes. The wages found below to be deductible were those paid to induce the employees to engage in criminal conduct. It is also our view that the words "trade or business" as used in Section 23 mean a lawful enterprise and do not cover criminal activities. Certainly one engaged in a legitimate business cannot deduct bribes or other illegal expenditures. Yet, if the court below is right, a taxpayer, by limiting himself exclusively to illegal activities, could convert such non-deductible expenditures into the "ordinary and necessary" expenses of carrying on a "trade or business." Further, we believe that the public policy rule declared by the Court in *Commissioner* v. *Heininger*, 320 U. S. 467, and in *Lilly* v. *Commissioner*, 343 U. S. 90, is applicable here, and that the statute should not be construed to allow deductions which would frustrate sharply defined national or state policies, embodied in criminal statutes, proscribing particular types of conduct.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

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MAY 1957.

APPENDIX

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In the United States Court of Appeals for the Seventh Circuit

SEPTEMBER TERM, 1956 JANUARY SESSION, 1957

Nos. 11841, 11842

NEIL SULLIVAN AND GRACE SULLIVAN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

JAMES ROSS AND ANN ROSS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

PETITIONS FOR REVIEW OF DECISIONS OF THE TAX COURT OF THE UNITED STATES

February 13, 1957.

Before LINDLEY, SWAIM and SCHNACKENBERG, *Circuit Judges.*

SCHNACKENBERG, *Circuit Judge.* Petitioners seek a review[1] of that part of decisions entered by the Tax Court of the United States which determined deficiencies in their income taxes for the years 1948, 1949, and 1950, and imposed penalties therefor. The only contested issue in the cases is whether or not petitioners may deduct for income tax purposes unlawful payments of wages and rent in connection with the unlawful operation in Illinois of a book-making establishment by petitioners Neil Sullivan and James Ross.

This legal issue was presented, argued and decided by this court in *Commissioner of Internal Revenue* v. *Doyle,* 231 F. 2d 635, where the Commissioner himself stated the question there presented to us for decision, in this language: "Whether expenses for rent and wages incurred in the operation of an illegal gambling business are themselves contrary to a sharply defined and declared public policy of the state of Illinois and hence are not deductible for income tax purposes, within the meaning of sec. 23 (a), Internal Revenue Code of 1939. In our opinion, we accepted and decided the question as thus stated. In this case, the Commissioner states the contested issue thus: Whether a taxpayer may deduct for income tax purposes payments of rent and wages which were made in violation of criminal statutes of the state of Illinois.[2] It does not appear that the Commissioner applied to the United States Supreme Court for *certiorari* to review our decision in the *Doyle* case. It does appear that, before a single judge of the Tax Court who tried the

[1] These cases came from the Tax Court on a consolidated record.

[2] In the *Doyle* case, the Commissioner relied on only the following statutes of the state of Illinois: §§ 139, 140, 336 and 582, chapter 38 (Criminal Code) Illinois Revised Statutes, 1945. He relies upon the same statutes in the case at bar.

case at bar, the Commissioner contended and now contends that the holding of this court in the *Doyle* case should not be followed. If the Commissioner feels that the decision in the *Doyle* case was wrong he should have, by application for *certiorari*, afforded the Supreme Court an opportunity to pass upon his contentions. Lacking such a decision by the highest court, a decision by one judge of the Tax Court, which, in effect, overrules a decision of the court of appeals in the circuit in which both cases arose, is not consonant with the responsibilities of the respective tribunals involved. To the same effect is *Stacey Mfg. Co.* v. *Commissioner of Internal Revenue*, 237 F. 2d 605.

Our opinion in the *Doyle* case neither expressly treated, nor by any possible inference can be construed as treating, the wages and rent paid by the taxpayer as "legitimate" expenses. The word "legitimate", upon which the Commissioner now relies in an attempt to disfinguish the *Doyle* case, was used by the Tax Court in its decision in the *Doyle* case, but not by us. We made it clear, at 636, that sec. 23 (a),[3] in setting forth what trade or business expenses are to be deducted from gross income in computing net income, makes no distinction between *lawful* and *unlawful* disbursements.

On the authority of the *Doyle* holding, to which we adhere, the decision of the Tax Court is reversed and the cause is remanded[4] for the sole purpose of a redetermination of the penalties, if any, assessable solely on the basis of income reported by petitioners in their returns.

Reversed and remanded.

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[3] 26 U. S. C. A. § 23 (a).

[4] 26 U. S. C. A. § 7482.

In the United States Court of Appeals
For the Seventh Circuit

No. 11841

NEIL SULLIVAN AND GRACE SULLIVAN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

PETITION FOR REVIEW OF A DECISION OF THE TAX COURT OF THE UNITED STATES

Wednesday, February 13, 1957

Before LINDLEY, SWAIM, SCHNACKENBERG, *Circuit Judges.*

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on March 19, 1956 be, and the same is hereby, *Reversed,* and that this cause be, and the same is hereby, *Remanded* to the said Tax Court of the United States for the sole purpose of a redetermination of the penalties, if any, assessable solely on the basis of income reported by petitioners in their returns, in accordance with the opinion of this Court filed this day.

In the United States Court of Appeals for the Seventh Circuit

No. 11842

JAMES ROSS AND ANN ROSS, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

PETITION FOR REVIEW OF A DECISION OF THE TAX COURT OF THE UNITED STATES

Wednesday, February 13, 1957

Before LINDLEY, SWAIM, SCHNACKENBERG, *Circuit Judges.*

This cause came to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on March 19, 1956 be, and the same is hereby, *Reversed*, and that this cause be, and the same is hereby *Remanded* to the said Tax Court of the United States for the sole purpose of a redetermination of the penalties, if any, assessable solely on the basis of income reported by petitioners in their returns, in accordance with the opinion of this Court filed this day.

In the United States Court of Appeals for the Seventh Circuit

SEPTEMBER TERM, 1956 JANUARY SESSION, 1957

No. 11775

SAM MESI, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

April 5, 1957

Before DUFFY, *Chief Judge*, and SWAIM and SCHNACKENBERG, *Circuit Judges*.

SCHNACKENBERG, *Circuit Judge*. Sam Mesi, hereinafter referred to as the taxpayer, by his petition asks us to review a decision of the tax court which decided that there is a deficiency in his income tax for the year 1946 in the amount of $10,887.77. The tax court made findings of fact and rendered an opinion.[1]

During the year 1946, taxpayer was engaged in the business of accepting wagers on horse races, commonly known as bookmaking. He had a principal location for which he paid an annual rental. Incoming bets totaled $793,287.50 in 1946. He employed 6 or 7 persons during that year, paying them gross wages in the amount of $14,563.84. Among these employees were a cashier, 2 or 3 sheet writers who ac-

[1] Reported in 25 T. C. 513.

cepted and entered the incoming bets, men on the "hard cards," and a doorman. The total ins, the total outs, the gross profit, and the percentage of gross profit to ins, for the year 1946, according to monthly summaries kept by the taxpayer and his return for that year are as follows:

Total Ins	$793,287.50
Total outs	750,069.85
Gross Profit	$43,217.65
Percentage of Profit	5.45

As interpreted by respondent, the tax court determined "that the wages paid to employees in taxpayer's illegal gambling enterprise were not deductible since the payment of the wages violated the criminal statutes of Illinois and the deduction of such wages would tend to frustrate the declared public policy of that state."

The tax court disallowed $5,000 of the betting losses claimed by the taxpayer.

1. The tax court erroneously failed to allow as deductions wages proved to have been paid by taxpayer to his employees in carrying on his business. We so held in *Commissioner of Internal Revenue* v. *Doyle*, 231 F. 2d 635, affirming the tax court's memorandum decision, P-H T.C. Memo 54,340; and *Sullivan* v. *Commissioner*, No. 11841; *Ross* v. *Commissioner*, No. 11842, decided February 13, 1957, —— F. 2d ——. It is therefore necessary for us to, and we do, reverse the decision of the tax court to that extent.

2. A part of the judgment of the tax court rests upon its finding of fact that taxpayer overstated his deduction for wagering losses on his return in the amount of $5,000. As to how this figure was arrived at, the record does not fully disclose.

While respondent determined that $48,010.41 of the losses claimed by taxpayer must be disallowed because

his reported gross profit amounted to but 5½%, whereas the pari-mutuel machines in the state of Illinois operated on a gross profit of 11½ or 12½ per cent, depending upon their location, the tax court discarded this ground for disallowance as being not justified.

The tax court found that the parties have stipulated that petitioner's records for one day[2] during the year 1946 are to be considered typical of his records for that entire year. There is no written stipulation to this effect in the record. We have examined large parts of the colloquy of counsel upon the trial before the tax court and we are unable to find a clear stipulation to that effect. Upon what, if anything, the counsel agreed, is vague and elusive. The briefs in this court do not clarify the subject.

In the notice of deficiency furnished by respondent to the taxpayer, it is stated that the excess of "gaming receipts over gaming disbursements, or gross receipts reported by you in your income tax return for the taxable year 1946 in the amount of $43,217.65 has been increased by [*sic*] $48,610.41 *on the basis of information on file in the Bureau* * * *." (Italics supplied.) The record does not show what this information was. It is axiomatic that a judgment of the court cannot rest upon facts not presented to it.

It follows that, as to the disallowance of $5,000 of taxpayer's betting losses, the decision of the tax court must be, and it is hereby, reversed and the cause remanded to that court for further proceedings in reference to that subject only.

Reversed in part and remanded in part, for further proceedings.

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[2] March 16, 1946.

In the United States Court of Appeals

For the Seventh Circuit

No. 11775

SAM MESI, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Friday, April 5, 1957

Before DUFFY, *Chief Judge*, and SWAIM, and SCHNACKENBERG, *Circuit Judges*.

PETITION FOR REVIEW OF A DECISION OF THE TAX COURT OF THE UNITED STATES

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on February 9, 1956 be, and the same is hereby, *Reversed* in part *Remanded* in part to the said Tax Court of the United States for further proceedings in accordance with the opinion of this Court filed this day.

In the United States Court of Appeals
For the Seventh Circuit

OCTOBER TERM, 1955 JANUARY SESSION, 1956

No. 11572

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES V. DOYLE AND CLARA DOYLE, RESPONDENTS

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

April 11, 1956

Before MAJOR, FINNEGAN and SCHNACKENBERG, *Circuit Judges.*

SCHNACKENBERG, *Circuit Judge.* This petition for review involves income taxes and penalties of $7,223.75 for 1948, 1949 and 1950, and questions the correctness of a decision of the Tax Court entered on January 26, 1955. The petition was filed by the Commissioner on April 25, 1955, pursuant to sec. 7482 of the Internal Revenue act of 1954.[1]

As expressed in the words of the Commissioner, the question presented is whether expenses for rent and wages incurred in the operation of an illegal gambling business are themselves contrary to a sharply defined and declared public policy of the state of Illinois and hence are not deductible for in-

[1] 28 U. S. C. A., § 7482.

come tax purposes, within the meaning of sec. 23 (a), Internal Revenue Code of 1939.[2]

During the taxable years, the taxpayer, Charles V. Doyle,[3] hereinafter referred to as respondent, was engaged in accepting wagers on horse races, herein referred to as bookmaking or operating a handbook, in the state of Illinois. Respondent paid rent for a room in Chicago where he accepted, recorded and paid the wagers. In the conduct of this business respondent paid wages to several employees.

The Commissioner contends that the Tax Court erred in allowing these amounts to be deducted from the gross income of the respondent.

The blueprint for this decision is to be found in sec. 23 of the Internal Revenue Code of 1939.[4] Relevant provisions thereof read as follows:

> "SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) [as amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In General.* All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

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[2] 26 U. S. C. A. § 23 (a).

[3] Clara Doyle is a party by reason of filing joint returns with her husband, the respondent. She will not be further referred to in this opinion.

[4] 26 U. S. C. A. § 23.

Sec. 23 (a), in setting forth what trade or business expenses are to be deducted from gross income in computing net income, makes no distinction between lawful and unlawful disbursements. The act says that there shall be allowed as deductions all ordinary and necessary expenses paid or incurred in carrying on any trade or business, including a reasonable allowance for salaries and rentals for use of property for purposes of the trade or business.

Both parties agree that gross income includes income from a trade or business regardless of its lawfulness or unlawfulness. But the Commissioner would include the element of lawfulness of expenses of rent and salaries of a trade or business as a requirement for their deductibility, in addition to the act's requirement that said expenses be "ordinary and necessary". Here is "clear Congressional action" contrary to the Commissioner's position. *Textile Mills Sec. Corp.* v. *Commissioner*, 314 U. S. 326, at 328. The Commissioner would have us add the word "lawful" in the guise of judicial construction. This is a taxing statute. The congress by this act purposed the raising of revenue rather than the furnishing of aid to the enforcement of the state's criminal laws. In imposing an income tax, the congress draws no distinction between income from a lawful business and income from an unlawful business. It is not concerned with the source.

The language of sec. 23 is clear and unambiguous. Its application to this case requires an affirmance of the Tax Court's decision. However, because of the exhaustive brief filed by the Commissioner, in which he attempts to justify his contention that the Tax Court erred, we shall not end this opinion at this point, but shall discuss the Commissioner's arguments and the principal cases upon which he relies.

In the situation in which we find ourselves, we have no right to let our natural antipathy to respondent, because of the unlawfulness of his business, deter us from objectively applying the law as it is written. Lawful or unlawful, the government has seen fit to impose a tax upon respondent's business. That business, like most businesses, has in-take and out-go. The Commissioner would have us consider that business as divided into three parts: (1) the gross income, (2) the amounts paid for salaries and rent and (3) other expenses of the business. As we shall see, the Commissioner, in computing respondent's income tax, takes into account (1) and (3) and discards (2). This is confusing because (2) is expressly recognized as a proper deduction by sec. 23 (a), and (3) is also recognized, but not specifically. However, the business is not susceptible to the assumed division. The business, whose income the government seeks to tax, is a unit. Its income is as unlawful as any of its ordinary and necessary expenses. They are all integral parts of a whole tree whose fruit the Commissioner would tax. He is inconsistent when he concedes that the following expenses in part (3) are deductible: lights, forms and scratch sheets, repairs, supplies, telephone, wall sheets, armored express, wire service, safety tickets, depreciation, auditing, currency exchange, stationery and printing, laundry, etc., totalling for 1948, $6,909.53, for 1949, $6,615.59, and for 1950, $6,357.43.

From sec. 23 (a) we find that an allowable deduction claimed for an expense in carrying on a business must be ordinary and necessary, nothing more or less. In what amounts to a partial recognition that this is true, the Commissioner admits as proper deductions respondent's expenses for telephone, printing and other items; none of them specifically mentioned in the act.

It is clear that salaries and rent are ordinary and necessary to the carrying on of the business of a handbook just as the admitted expenses are. Moreover, the act specifically mentions salaries and rent. Economically they are as much as integral part of the business as is the receipt by the handbook operator of moneys paid on bets.

We construe the statutory words "ordinary and necessary expenses" to mean those expenses which economically are an integral part of a business, whether it be lawful or unlawful. Integrality is the test. Disbursements which fail to meet this test, although they may be concomitants to the business as operated by some persons, are not ordinary and necessary expenses thereof within the meaning of sec. 23(a). We exclude and, therefore, hold as non-deductible, expenses which are not an integral part of a business. In this class fall bribes paid to public officers,[1] fines and penalties imposed for violations of federal or state statute,[2] expenses for certain types of lobbying and political pressure activities,[3] payments to an influential party precinct captain, in order to obtain a state printing contract[4] and other similar disbursements.[5]

As illustrative, we find it helpful to apply the test to two simple situations. An ordinary grocer, who bribes a policeman to let him place his wares on a public sidewalk in front of his store in violation of a municipal ordinance, cannot deduct the amount of the

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[1] *United States* v. *Sullivan*, 274 U. S. 259, 264.

[2] *Great Northern Ry. Co.* v. *Commissioner*, 40 F. 2d 372 and *Lentin* v. *Commissioner*, 226 F. 2d 69.

[3] *Textile Mills Sec. Corp.* v. *Commissioner*, 314 U. S. 326.

[4] *Rugel* v. *Commissioner*, 127 F. 2d 393.

[5] See *Heininger* v. *Commissioner*, 320 U. S. 467 (affirming this court, 133 F. 2d 567).

bribe as an ordinary and necessary expense of his grocery business. The payment is a concomitant, but not an integral part, of the grocery business. If a handbook operator takes over the store used by the grocer and bribes the same policeman to permit the placing of chairs for the bettors on the same sidewalk in violation of the same ordinance, that payment would for the same reason be nondeductible. The payment is a concomitant, but not an integral part, of the handbook business. Both the grocer and the handbook operator, during their respective occupancies of the store, would be entitled to deduct on their income tax returns expenditures for salaries of clerks, rent of the store and other ordinary and necessary expenses of their businesses, because such payments are an integral part of the business.

To the extent that such ordinary and necessary expenses exist, a holding that they are undeductible by a handbook operator in a state in which the business is unlawful, would mean that such a tax would be levied by the federal government on gross income, while a holding that they are deductible in a state in which the business is lawful, would mean that such a tax would be levied on only net income. We cannot believe that the congress intended this inequitable result. Certainly the clear language of the act does not suggest that such consequences were contemplated by the congress.

Other examples illustrate the fallacy of the Commissioner's contention. Thus one state may prohibit the business of selling automobiles on Sunday, while another may not. Would the Commissioner argue that a dealer who did business on Sunday in the first state could not deduct from his gross receipts salaries and rent paid for his unlawful activity on that day, while a dealer in the second state could make such deduc-

tions? In some areas the sale of intoxicating liquor at retail is legal, and in others it is illegal. Would a retailer's salary and rent payments be deductible or not depending entirely on the lawfulness of his business?

Cases might arise in which the charge of unlawfulness might be denied. In the absence of a criminal trial to resolve the question of the taxpayer's guilt, is that question to be tried by the Commissioner and the Tax Court in tax proceedings? Such a situation might arise from the Commissioner's argument, based on the Illinois statute's provision that an owner, who knowingly permits his property to be used for gambling, shall be subject to punishment, and the further provision that an accessory to the perpetration of a crime shall be punished as a principal. He argues that respondent, in paying rent for his leased handbook premises, is an accessory to the crime of the landlord. If this theory is tenable, someone must determine whether the landlord *knowingly* permitted the illegal use of his premises. Is this question to be determined in a proceeding to which the landlord is not a party? If so, who is to make that determination,—the Commissioner and the Tax Court? These questions are suggestive of the many surprising results which would follow the adoption of the Commissioner's theories. We cannot believe that they were intended by the congress. The clear language of sec. 23 is a bar to such excursions as the Commissioner's contentions would invite.

The Commissioner should have allowed salaries and rent as deductions under sec. 23 (a). Hence the Tax Court's decision is correct and is affirmed.

We feel that it is important to call the attention of the Commissioner to the fact that in this and other cases before us his counsel repeatedly ignore rule 16

(c), (d) and (e), of this court regulating the contents of briefs.

Affirmed.

FINNEGAN, *Circuit Judge*. Dissenting. Book-making is a statutory criminal offense in Illinois. (Ill. Rev. Stat. 1955, chap. 38, par. 336). It is undisputed that appellee Charles V. Doyle operated " a bookmaking establishment" in that State for the tax years involved. Shortly stated the question is, can Doyle's disbursements for salaries and rents incurred in his illegal enterprise be classed "ordinary and necessary" under § 23 (a) (1), Internal Revenue Code of 1939. Under the Illinois statute Doyle's expense items are unnecessary, though perhaps ordinary. But for deductibility as business expenses in computing federal income taxes, the Congressional mandate requires both elements—ordinary and necessary. I am unable to ignore the public policy of Illinois manifested by its statute proscribing the behavior generating Doyle's items of rent and salaries. The "temerity to raise" such deductibility was long ago anticipated in another case. *United States* v. *Sullivan*, 274 U. S. 259, 264 (1927). I would reverse the Tax Court decision and remand this case with directions to disallow the deductions claimed.

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